

Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [REDACTED]:TL-N-2991-00
[REDACTED]

date: JUN 23 2000

to: Chief, Examination Division, [REDACTED] District
Attn: Manager, Group [REDACTED] [REDACTED]

from: District Counsel, [REDACTED] District

Stop [REDACTED]

subject: [REDACTED] Legislative Changes

This memorandum responds to yours of May 8, 2000, and previous oral inquiries. In connection with the taxpayer's protest for the taxable years [REDACTED]-[REDACTED], you have requested our advice concerning the effect of certain amendments that the Legislature in [REDACTED] made to Section [REDACTED] of the "[REDACTED] Insurance Code Article [REDACTED], for federal income tax purposes. Specifically, what impact do these changes have on the analysis of whether the taxpayer is an integral part of the State of [REDACTED] as set forth in TAM-[REDACTED] [REDACTED]?

We summarize below the changes made to the relevant portions of § [REDACTED]:

Sub-section	Prior to [REDACTED] Amendments
[REDACTED]	[REDACTED] ("Association") shall either establish a reinsurance program or enter into a contract as provided in subsection ([REDACTED]). [REDACTED] Department of Insurance ("[REDACTED]") may approve any reinsurance program.

([REDACTED]) ([REDACTED])	Association may enter into written agreement with [REDACTED] under which Association members agree to relinquish their net equity on annual basis by making payments to the [REDACTED] to be held by [REDACTED]
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After [REDACTED] Amendments
Association shall either establish a reinsurance program approved by the [REDACTED] or make payments into the [REDACTED] ("[REDACTED]") (taxpayer) established under subsection ([REDACTED]). Association may establish a reinsurance program that operates in addition to or in concert with [REDACTED]. Commissioner of Insurance ("Commissioner") shall adopt rules under which Association members agree to relinquish their net equity on annual basis by making payments to the [REDACTED] to fund

outside State Treasury to protect Association's policyholders and reduce potential for payments by Association members giving rise to tax credits in the event of losses.

its obligations under section [REDACTED] and to fund the mitigation and preparedness plan established under subdivision (b) of this subsection to reduce potential for payments by Association members giving rise to tax credits in the event of losses.

Until disbursements are made as provided by this Act and the rules to be adopted by the Commissioner, all money (including investment income) deposited in the [REDACTED] are state funds to be held by the comptroller outside the state treasury on behalf of, and with legal title in, the [REDACTED].

No disposition of [REDACTED] funds [REDACTED] may be terminated only upon termination provided in by law. On termination, all the statute, but the written assets of the fund revert to agreement now in effect requires that these be used the state to be used to fund the annual loss mitigation for reinsurance. and preparedness plan.

(b) [REDACTED] shall be kept and maintained by [REDACTED] pursuant to the written agreement between Association, [REDACTED], State Treasurer, and Comptroller. Legal title to fund assets in the [REDACTED] until paid out as provided in the agreement. State Treasurer, as custodian, to administer the funds as provided by the agreement. State may not take any action with respect to the [REDACTED] other than as specified by this act and the agreement.

[REDACTED] shall be kept and maintained by [REDACTED] pursuant to this act and rules adopted by the Commissioner. Comptroller, as custodian, to administer the funds as provided by this Act and Commissioner's rules.

- () () On effective date of agreement, all funds held by Association may be paid to [REDACTED]. At the end of each calendar or policy year, Association may pay the net equity of a member, including all premium and other revenue of the Association in excess of incurred losses and operating expenses, to [REDACTED] or a reinsurance program approved by the Commissioner.
- () () The written agreement shall establish the procedure relating to the disbursement of funds from the [REDACTED] to policyholders in case of occurrences that result in insured losses and operating expenses of the Association greater than \$ [REDACTED].
- () () No provision
- At the end of each calendar or policy year, Association shall pay the net equity of a member, including all premium and other revenue of the Association in excess of incurred losses and operating expenses, to [REDACTED] or a reinsurance program approved by the Commissioner.
- Commissioner's rules shall establish the procedure relating to the disbursement of funds from the [REDACTED] to policyholders in case of occurrences that result in a disbursement under Section 19(a).
- Each state fiscal year, beginning with fiscal [REDACTED], [REDACTED] may use from the [REDACTED]'s investment income not less than \$ [REDACTED] and not more than [REDACTED] % of its investment income for the prior fiscal year to fund an annual mitigation and preparedness plan to be developed and implemented each year by the Commissioner, including up to \$ [REDACTED] for the [REDACTED] inspection program in Section [REDACTED]. The plan is to provide steps to be taken by the Commissioner (or other entity that he designates) to implement programs to improve preparedness for and reduce losses from [REDACTED] and [REDACTED], provide research to reduce those losses, inform the public about appropriate upgrades to structures, or

protect infrastructure from those [REDACTED]. Money in excess of \$ [REDACTED] is not available for the plan if the Commissioner determines that spending it would jeopardize the [REDACTED]'s actuarial soundness or impair its ability to serve the "state purposes" for which it was established.

The effective date of the changes is [REDACTED]. In the Act amending Art. [REDACTED], the Legislature also made statutory findings that were not placed in the Insurance Code. These include:

- The [REDACTED] was formed to shelter the state's general revenue from dissipation due to [REDACTED] losses from [REDACTED] and as part of the state's planning and provision for relief from those losses.
- The state's interest in protecting its general revenue and in planning and providing for [REDACTED] losses is benefitted to the extent the [REDACTED] is funded.
- The legislature's original intent was to establish the [REDACTED] as a state fund exempt from federal and state income taxation.
- The Internal Revenue Service has suggested that the [REDACTED] is subject to federal income taxation.
- Section [REDACTED] and () should be clarified and amended consistent with the legislature's original purpose and intent.
- The Association is state-mandated for the well-being of the state's [REDACTED] residents and businesses by ensuring the availability [REDACTED] and [REDACTED] insurance coverage in designated areas.
- Each year, the Association is required to pay its net equity to the [REDACTED] or use it to purchase reinsurance approved by the Commissioner.

It is obvious that these changes were enacted solely because of our examination of the Association and [REDACTED]. Nevertheless, they are law and must be considered. But the legislature's

"determinations" do not matter; what is important are the substantive changes, if any, that the new legislation makes in terms of the [REDACTED]'s ownership, sources of funding, operations, etc. These are discussed below.

§ [REDACTED].--There is no real change here. Under both old and new law, the Association can either establish a reinsurance program or pay into the [REDACTED]. The old law provided for a written agreement which has now been removed. The old law provided that the [REDACTED] "may" approve any reinsurance program. This has been made mandatory by the new law. The new law also clarifies that the Association's reinsurance program may operate in conjunction with the [REDACTED], but it has already been doing this for some time.

§ [REDACTED].--Under the old law, the Association could enter into a written agreement with the [REDACTED] under which the members could relinquish their net equity on an annual basis by making payments to the [REDACTED]. These funds were to be held by the [REDACTED] outside the State Treasury for the stated purposes (a) to protect Association's policyholders and (b) reduce the potential for payments by Association members giving rise to tax credits in the event of losses (Tier 4 payments).

The new law replaces the written agreement requirement with rules to be adopted by the Commissioner. The new stated purposes of the [REDACTED] funds are (a) to fund its obligations under Section [REDACTED] to fund the mitigation and preparedness plan established under subdivision (■) of this subsection and (■) to reduce the potential for payments by Association members giving rise to tax credits in the event of losses. Conspicuously omitted is the purpose to protect the Association's policyholders.

The new law also provides that the [REDACTED] funds are "state funds" to be held by the Comptroller "outside the state treasury" on behalf of, and with legal title in, the [REDACTED].

The old law contained no provision regarding disposition of the [REDACTED]'s assets upon termination. The written agreement, however, requires that they be used to purchase reinsurance. Under the new law, the [REDACTED] may be terminated only by law. On termination, all assets of the fund revert to the state to be used to fund the annual loss mitigation and preparedness plan.

The only changes here are replacing the written agreement with [REDACTED] rules, changing the stated purposes of the [REDACTED] declaring that the [REDACTED] assets are "state funds," and inserting termination provisions. Functionally, there is no real change. Even though they are labeled "state funds," the [REDACTED] funds are

still to be held outside the state treasury and thus not subject to annual appropriation by the Legislature. The funds are also still used for the Tier 2 losses under Section [REDACTED] which benefits the Association members to the same extent as before. In fact, the new statute clarifies that one of the purposes of the [REDACTED] is to fund its obligations under that section. The application of the funds upon termination is different but not significantly so. Instead of purchasing reinsurance, they are to be used to fund the annual mitigation and preparedness plan designed to reduce losses from windstorms. New Section [REDACTED]. This benefits the Association members as much as the reinsurance, since both applications ultimately reduce covered losses.

§ [REDACTED].--The only change here is formal. The [REDACTED] is to be administered by the Comptroller rather than the Treasurer (whose office has been eliminated) pursuant to the [REDACTED]'s rules rather than a written agreement.

§ [REDACTED].--There is a substantive change here. The new law provides that the Association "shall" pay the net equity of a member to the [REDACTED] or a reinsurance program. We feel that the use of the term "may" is very significant in the old law.

§ [REDACTED].--No real change here. Disbursements are to be made pursuant to the [REDACTED]'s rules rather than the written agreement.

§ [REDACTED].--This provision is new. It allows the [REDACTED] to use certain amounts of the [REDACTED]'s investment income for the [REDACTED] inspection program in Section [REDACTED] and to create an annual mitigation and preparedness plan designed to improve preparedness for and reduce losses from [REDACTED] and [REDACTED], provide research to reduce those losses, inform the public about appropriate upgrades to structures, or protect infrastructure from those [REDACTED]. Amounts in excess of \$ [REDACTED] are not available, however, if the Commissioner determines that spending them would jeopardize the [REDACTED]'s actuarial soundness or impair its ability to serve the "state purposes" for which it was established. By reducing potential losses from [REDACTED], these programs would benefit the Association members at least as much as the State. It would seem that this provision was added to give the appearance of increased state control over the [REDACTED]'s income while in substance constricting its exercise to the members' benefit.

Overall, we believe that these changes were cosmetic and undertaken solely to avoid federal income taxation of the [REDACTED]'s income. We do not believe that they alter the TAM's analysis or conclusions. The significant facts have not changed. The [REDACTED]'s

funds all originate from the Association members and policyholders. No taxpayer money is involved. The legislature has no power to authorize or appropriate any of the funds. And the benefit flow of the funds have not changed. The Association members are still the primary beneficiaries of the monies. Further, the State has no greater financial commitment to the [REDACTED] under the new law than under the old.

In any event, the changes could not affect any taxable year ending before their effective date of [REDACTED].

This concludes our advice on the matter requested. Please contact the undersigned with any questions at [REDACTED]. We are sending a copy of this advice to our National Office for post-review.

[REDACTED]
District Counsel

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Attorney